Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

JUN 12 1996

In the Matter of	)	
	)	
	)	
Allocation of Costs Associated with	)	
Local Exchange Carrier Provision of	)	CC Docket No. 96-112
Video Programming Services	)	

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REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

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SUMMARY[1]

In its reply comments, SWBT responds to parties that argue that Part 64's flexible cost-causative allocation principles are no longer adequate, that the Commission should force all LECs to use a uniform fixed allocation factor to over-allocate costs to video programming activities, and that the modified cost allocation rules should trigger a punitive exogenous cost reduction in price cap indices.

Cable commenters suggest several weak arguments in support of the NPRM's conclusion that the cost-causative cost allocation principles in Part 64 are no longer adequate. None of these arguments withstands close scrutiny. While cable commenters claim that cost-causative allocation of loop plant is impossible, SWBT and other commenters show that cost-causative methods are indeed available for loop plant and other categories of cost associated with video programming. The availability of reasonable cost-causative methods of directly or indirectly attributing video programming costs makes it unnecessary and improper to prescribe fixed allocation factors or other arbitrary methods. Unlike flexible Part 64 cost allocation principles, fixed allocation factors fail to consider the increasing radical diversity of the LECs' future networks and operations. Use of fixed factors in the Part 36 jurisdictional separations is distinguishable because those fixed factors are based on a number of years of experience that yielded factors that remained stable over time. In view of minimal experience with integrated broadband LEC networks and the growing diversity in the market, it would be unreasonable to prescribe uniform fixed allocation factors. The TSLRIC method suggested by AT&T and MCI is

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[1]Abbreviations used herein are referenced within the text.

especially inappropriate because, among other reasons, it is contrary to Part 64's full allocation of costs to exclude a substantial portion of the common costs supporting all regulated and nonregulated activities.

The Commission should consider carefully the unintended consequences that adoption of mandatory fixed factors, cost ceilings or other arbitrary allocation methods could have for other proceedings that may continue to rely on calculations of the regulated portion of historical or embedded costs.

Among other flaws, use of the NPRM's proposed cost allocation methods to force exogenous cost reductions of regulated price indices would be contrary to the goals of price cap regulation, would discourage efficient deployment of innovative services and would impede LECs' effective competitive entry into the concentrated video market.

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REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company ("SWBT") hereby respectfully submits these reply comments in connection with the Commission's Notice of Proposed Rulemaking (FCC No. 96-214)("NPRM") in the above-referenced proceeding.

I. ARGUMENTS FOR CHANGING ALLOCATION METHODS UNDER PART 64 ARE WEAK

In authorizing four entry options for local exchange carriers ("LECs") to provide video programming in the Telecommunications Act of 1996 (the "96 Act"), Congress recognizes that "there can be different strategies, services and technologies for entering video markets."[1] According to Congress, the intent of these multiple entry options is to promote competition, to encourage investment in new technologies and to maximize consumer choice of services that best meet their information and entertainment needs."[2] Faced with a convergence of diverse competitors and a divergence of architectures and technologies "for the delivery of various

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[1]Conference Report at 172.

[2]Id.

combinations of narrowband and interactive broadband services,"[3] the NPRM proposes (1) to force all LECs to use the same, uniform factor to allocate network and other costs associated with video programming and other nonregulated services and (2) to use the price cap exogenous cost rule to penalize any LEC that would dare to use an efficient integrated network to enter the video market.

A number of commenters explain that changes in the marketplace and the 96 Act do not require adoption of the NPRM's proposals because the existing Part 64 rules -- to the extent they are still necessary under price caps -- are more than sufficient to the cost allocation task.[4] In fact, their flexibility makes them much more suitable to the task than the NPRM's inflexible methods.

The NPRM gave two reasons for believing that Part 64 will no longer work in the new competitive environment: (1) allegedly Part 64 was not designed for, and did not anticipate, "substantial amounts of common costs for outside plant categories"[5] and (2) allegedly a cost-causative allocation of outside plant "is not possible" or would lead to results contrary to the 96 Act. Both of these reasons are rebutted by SWBT and other commenters, who describe various cost-causative allocation methods for regulated and nonregulated services, including video programming.[6] In addition, the Commission clearly anticipated substantial nonregulated use of the network when it adopted Part 64:

> AT&T's proposal ... would appear to produce skewed results in an

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[3]USTA, Appendix at 19

[4]GTE at 8; U.S. Sprint at 3; NYNEX at 7; Pactel at 6; USTA at 10, 17-18.

[5]NPRM, ¶18.

[6]See, e.g., Ameritech at 16-21; BellSouth at 19; Broadband Technologies, Inc. (BTI) at 7; NYNEX at 11; SNET at 17-18; Pactel at 9; USTA at 17-18; US WEST at 10-11.

> environment in which nonregulated services offered through the network are expected to grow dramatically.[7]

The cable lobby provides other inadequate justifications for abandoning Part 64's cost-causative methods in favor of fixed factors or other mandatory allocation methods. The California Cable TV Association ("CCTA") claims that Part 64 is inadequate due to (1) "inherent limitations" of Part 32 in not providing separate accounts for loops and trunks; (2) excessive LEC discretion; (3) less "traditional" and more far-reaching services to be offered in the future; and (4) the impossibility of "direct assignment" of facilities used for such new services.[8] CCTA is grasping at straws to find a justification that does not exist. Because Part 64 categorizes Part 32 costs into homogenous cost pools, which are often subcategories of a Part 32 account, any lack of detail in Part 32 does not limit the adaptability of Part 64 as technology evolves.[9] While the LEC's flexibility in designing cost pools and allocation methods aids in the adaptability of Part 64 to diverging architectures, technologies and services, it is subject to FCC review and approval, as well as periodic audits. CCTA's other two justifications merely echo the NPRM's contentions CCTA's contention regarding the impossibility of "direct assignment" is unavailing because SWBT and other commenters have shown that cost-causative methods other then direct assignment are indeed possible. These other methods directly or indirectly attribute plant costs

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[7]Joint Cost Recon Order, 2 FCC Rcd 6283, 6292, ¶83 (1987) (emphasis added).

[8]BellSouth at 18-19; CCTA at 6-7; GTE at 9; NYNEX at 11-13; Pactel at 9-10;

[9]In any event, CCTA's point is directed at alleged deficiencies in Part 32, which is beyond the scope of this proceeding. Other commenters raise issues beyond the scope of this proceeding, which the Commission should defer, such as NARUC's recommendations to initiate a broadband joint board proceeding to consider changes to Part 36. NARUC, *passim*.

based on measures of use or demand.[10]

Some commenters also contend that new video cost allocation rules are mandated by 47 U.S.C. §254(k).[11] However, Section 254(k) does not require the Commission to adopt new cost allocation rules to the extent that price cap regulation, competition and enforcement of existing cost allocation rules assure that competitive services are not subsidized. Since Section 254(k)'s prohibition against cross-subsidy applies to all carriers,[12] any rules adopted pursuant to it should be applied equally to all.

While Part 64 is not perfect and could benefit from some of the minor sprucing up and pruning suggested by some LECs,[13] it is more than sufficient to perform its original cost allocation task for those LECs that still require it. To the extent Part 64 is retained or made more onerous instead of being streamlined, it should be applied not only to incumbent LECs, but to all LECs and cable operators. As noted by some LECs, disparate treatment of LECs and cable operators is contrary to Congress' intent to promote video market competition.[14]

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[10]Other commenters also fail to consider methods of directly or indirectly attributing costs on a cost-causative basis under Part 64. For example, Comcast/Adelphia assumes that if "direct assignment" is not possible, then the next step is a "general allocation factor." Comcast/Adelphia at 5-6. Comcast/Adelphia is in error in stating that "the ratio of directly assigned plant [is] a general allocation factor." Comcast/Adelphia fails to consider multiple steps between direct assignment and a general allocator in the Commission's hierarchy of cost allocation principles.

[11]CCTA at 5.

[12]Ameritech at 9-10; BellSouth at 9. Section 254(k) is apparently going to be the subject of a separate proceeding. See footnote 29 infra.

[13]For example, SWBT agrees with suggestions to simplify Part 64, such as by allowing LECs the option of using an annual, rather than a quarterly, measure for the general allocator, if a LEC so chooses. Pactel at 19.

[14]E.g., BellSouth at 6-7; SNET at 22-24.

II. PRESCRIPTION OF UNIFORM FIXED FACTORS IS UNREASONABLE

Just as the cable commenters do not prove that Part 64's cost-causative allocation rules are inadequate, they also fail to prove that it is necessary to use a fixed factor or other arbitrary method. Instead, they focus on means of increasing the punitive impact of the NPRM's rigid cost allocation proposals, such as suggestions to combine "cost caps" and fixed factors that would allocate as much as 70% or more of the common costs to video. The LECs' comments, on the other hand, demonstrate that cost-causative methods are available, which methods avoid the need to consider fixed factors or other arbitrary methods. LECs also describe a number of problems associated with use of fixed factors, aside from being inherently arbitrary and not based on cost causation. For example, most of the LECs are concerned that a fixed factor would not take into consideration the increasing radical diversity of the LECs' future networks and operations.[15] "[A] divergence of ... technologies is occurring in the sense that a number of alternative architectures may evolve for the delivery of various combinations of narrowband and interactive broadband services."[16]

As the LECs observe, a fixed factor could not possibly be consistent with cost causation principles.[17] To be consistent with cost causation, allocation factors must allow the allocation of costs to change as regulated and nonregulated services develop and evolve. In order for a fixed factor to be consistent with cost causation principles -- as some of the cable and interexchange

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[15] E.g., BellSouth at 18; GTE at 7; PacTel at 7; US WEST at 7; USTA at 15-19.

[16] Affidavit of J. Gregory Sidak at 19 ("Sidak Affidavit"), attached to USTA Comments.

[17] See, e.g., BellSouth at 20-22; GTE at 7-8; PacTel at 13-15.

carrier ("IXC") commenters admit it should be[18] -- it would have to be market-specific and it would have to be constantly reviewed and updated. The procedures necessary to produce a fixed factor based on cost-causation would be more complex than existing Part 64 procedures.

Revealing another problem with fixed factors, NYNEX and PacTel distinguish the use of fixed factors in Part 36. The main distinction is that fixed factors in Part 36 are based on a number of years of experience that demonstrated that the jurisdictional percentages "remain stable over time."[19] For fixed factors to be meaningful, they must be reasonably based on years of actual experience that yield consistent results or trends.[20] Given the minimal experience with integrated broadband LEC networks and the rapidly evolving technological and service environment, it is obvious that there is an insufficient basis to consider a fixed factor --even if it were necessary to do so.[21] While most of the cable commenters want all LECs to be subject to the same uniform, nationwide fixed factor, a few commenters acknowledge that a fixed factor would need to have some basis in reality. For example, the New York DPS believes that, once there is more experience with video deployment, the factor should be adjusted to reflect "the extent to which LECs may use existing loop facilities to jointly provide regulated and

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[18]E.g., MCI at 8. Apparently, MCI incorrectly assumes that cost-causation can be achieved by using purported estimates of average stand-alone telephone network costs from a 7-year-old publication. Id. at 9.

[19]NYNEX at 14. See also PacTel at 15.

[20] Ameritech at 19; NYNEX at 14.

[21]The failure of those who support a large fixed video allocation to reach a consensus on the relative size of the allocation should be enough to demonstrate to the Commission the folly of the pursuit of a uniform fixed percentage. See, e.g., Continental Cablevision at 3, 5-6 (over 95%); NCTA at 19 (76%); New York DPS at 4 (50%); MCI at 7, 10 (38% or 46%).

nonregulated services."[22] Also acknowledging the need for some measure of cost causation, the Florida PSC would apply the 50% factor based on a count of the loops that have video capability, which is very similar to the cost-causative methods described in the comments of BellSouth, SWBT, SNET, and US WEST. Since reasonable measures of cost-causation are already available, LECs should be able to use these methods, instead of an arbitrary "cookie-cutter" approach based on some calculation of nationwide average costs, as suggested by some cable operators and MCI.[23] The cable operators and MCI do not even attempt to demonstrate that their fixed factor methods are superior to reasonable cost-causative measures.

AT&T's proposed method of calculating a fixed factor based on incremental cost studies has no more merit than any other fixed factor method of cost allocation and suffers from many of the same deficiencies. Total Service Long Run Incremental Cost ("TSLRIC") studies have no place in the context of Part 64's fully distributed method of allocating costs based on cost causation.[24] TSLRIC studies are not even appropriate for purposes of pricing of interconnection and network elements;[25] they certainly do not belong in a cost allocation system, which is intended to identify total regulated costs. Among other deficiencies, AT&T's TSLRIC method does not allow recovery of sunk costs from telephone customers, and thus, it unfairly saddles

[22]New York DPS at 3-4.

[23]CCTA at 19; MCI at 9.

[24]With little explanation and no mention of TSLRIC, MCI suggests a stand-alone cost allocator that appears to mirror AT&T's method. MCI at 6-7. SWBT also objects to MCI's method, in part because it is not adequately explained, but SWBT only addresses AT&T's.

[25]See Comments of SBC Communications Inc. filed on May 30, 1996 in Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, at 24-27 & Affidavit of Peter Temin.

customers of nonregulated services with all of the sunk costs.[26] Few methods could result in a more distorted allocation of costs than one that ignores a significant share of the costs to be allocated. In effect, what AT&T is suggesting is that all of the embedded costs incurred for the benefit of telephone ratepayers over the years (to the extent they are not "efficient, forward looking") should be directly assigned to nonregulated activities and either recovered from customers of nonregulated services or, more likely, not recovered at all.[27] AT&T's fixed factor is even more offensive to Part 64 than the NPRM's suggested fixed factor because it undermines the premise of a full allocation of costs underlying Part 64 Of course, any fixed factor approach is generally inconsistent with Part 64 because it ignores cost causation.

In any event, since cost-causative methods of allocation are possible, the Commission should reject all suggestions to use a fixed factor or any other method to over-allocate costs to nonregulated activities such as video programming.[28]

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[26]The common costs that are allocated between regulated and nonregulated activities under A&T's method exclude costs that are not "efficient, forward looking." AT&T at 5.

[27]Within the range between stand-alone cost and incremental cost, NPRM, ¶20, AT&T's method selects the low end for allocation to regulated telephone service, which implies that a method at or above the high end would apply to the allocation to nonregulated services. The advantage of a fully distributed system such as Part 64 is that, with a few exceptions, it generally treats the regulated and nonregulated categories the same This is why it can be a fair method of allocation.

[28]Most of the commenters that are in favor of using a cost ceiling, only recommend using it as an adjunct to a fixed factor. CCTA at 14-16; NCTA at 9; Pennsylvania Office of Consumer Advocate at 2, 11-14. Since SWBT and other LECs have already shown that a cost ceiling is unreasonable and arbitrary, it is not necessary to address in any detail the use of a cost ceiling as an adjunct to another method. See SWBT at 12-16. Consistent with one of SWBT's criticisms of a cost ceiling, one cable commenter observes that "[t]his concept is fraught with complexity" and "fails to meet the Commission's goal of simplicity." Cox at 8. Accord, Time Warner at 7.

III. THE COMMISSION SHOULD AVOID ACTION THAT WOULD CONFLICT WITH OTHER PROCEEDINGS

Use of fixed factors, cost ceilings or other arbitrary methods of determining the regulated portion of common costs may have unintended consequences for other proceedings. Methods that are unrelated to cost causation would distort any cost-based calculations that may continue to rely on LECs' historical or embedded costs. For example, to the extent that new Universal Service procedures to be adopted in CC Docket No. 96-45 would rely on regulated cost calculations, the Commission should not adopt cost allocation rules as a result of this NPRM that would conflict with objectives or principles of Universal Service.[29] Allocation methods adopted in this or other proceedings which distort actual embedded regulated costs would corrupt current and future Universal Service models. The Commission should consider the overarching issues and consequences carefully in order to avoid complicating other proceedings.

IV. EXOGENOUS TREATMENT OF COST ALLOCATION CHANGES WOULD BE IMPROPER

Several LEC commenters agree that the purpose of the exogenous cost rule in Section 61.45(d)(v) is very limited. Initial price caps indices were approved by the Commission and established based on accounting costs as of 1990. Section 61.45(d)(v) was not intended to apply

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[29] See In the Matter of Federal State Joint Board on Universal Service, CC Docket No. 96-45, FCC 96-93, Notice of Proposed Rulemaking and Order Establishing Joint Board, released March 8, 1996, ¶¶ 112-115. For example, the Universal Service proceeding is considering "questions relating to the recovery of interstate-allocated subscriber loop costs," id. ¶114, and fixed factor reductions in regulated costs as a result of action in this NPRM (CC Docket No. 96-112) could dramatically impact the loop costs used in the calculation of explicit Universal Service support recovery. Such Universal Service issues are supposed to be considered in CC Docket No. 96-45, or a related proceeding; not in this NPRM regarding video programming and other nonregulated costs. See id. n.32 ("We are planning to commence a rulemaking shortly to implement ... accounting safeguards for universal service support mechanisms.").

to the allocation of new investment placed after 1990 or to other post-1990 changes in the costs of regulated and nonregulated investment,[30] rather, it was intended to deter under-forecasting of nonregulated usage pursuant to Section 64.901(b)(4).[31] The Commission should reject some commenters' suggestions to interpret Section 61.45(d)(v) to require a price cap adjustment for any and all reallocations of investment from regulated to nonregulated activities.[32]

In any event, use of cost allocation rules to force an exogenous cost reduction in price cap indices is at best unnecessary and at worst anticompetitive, and would result in sub-optimal pricing and provisioning incentives. Since pricing in competitive markets is not based on arbitrary cost allocation methods or rules, use of such rules to manipulate pricing under price caps would be contrary to the goals of price caps to "more closely replicate the operation of competition"[33] and "to encourage the deployment of new, innovative services."[34] Cable and IXC commenters make various arguments for using this NPRM's cost allocation proposals to reduce price cap indices. Some claim a reduction is necessary to prevent cross-subsidy, but they ignore that price cap regulation and competition are already effective safeguards against cross-subsidy.[35] Such claims also ignore the economic definition of cross-subsidy as the inadequacy of

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[30]Bell Atlantic at 7; Pactel at 18.

[31]Bell Atlantic at 7; BellSouth at 11; NYNEX at 22

[32]AT&T at 10-11; MCI at 16. But cf. BellSouth at 11 (quoting AT&T Price Cap Order, 4 FCC Rcd 2873, 3019-20, ¶302 (1989)).

[33]Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd 8961, 9002 ¶92 (1995).

[34]Id. ¶65.

[35]Affidavit of William E. Taylor at 7 ("Taylor Affidavit") attached to SNET Comments; Sidak Affidavit at 13-18.

additional revenues from a service to cover its additional costs.[36] Some of these commenters also claim a reduction is required by the economies of scope of an integrated broadband network. As articulated by the NCTA, this argument holds that "as a matter of public policy, ... the local telephone ratepayer should share in the efficiencies provided by an integrated broadband network."[37] As noted by Broadband Technologies, Inc ("BTI"), echoing the explanation in LECs' comments, increases in LEC productivity resulting from integrated systems are "precisely the types of activities price caps were designed to stimulate."[38] As BTI explains, reallocations should not be treated as exogenous because it would "take away the gains [LECs] achieve from the major innovation (and risk) of upgrading their networks,"[39] thus creating an incentive for LECs to construct inefficient stand-alone video networks. Broadband networks are being built to deliver not only nonregulated video but also a variety of advanced regulated services, which the 96 Act seeks to encourage. If price cap regulation reverts to cost-based methods to effectively preclude nonregulated services such as video programming, no one will receive the benefits of an integrated broadband network and video programming service will not contribute at all toward the cost of the integrated network. In any event, as several LECs note, telephone

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[36]Taylor Affidavit at 2-5. Measured against this true economic meaning of cross-subsidy, cable operators' claims that most, if not all, common costs must be allocated to video services to prevent cross-subsidy are absurd. NCTA at 15 (claiming that in some circumstances, even a 100% allocation to video would be insufficient protection against cross-subsidy). In addition, these extremist arguments reveal that the cable lobby's positions are merely transparent efforts by the dominant players in the video market to exclude or impair potentially effective competitors.

[37]NCTA at 24.

[38]BTI at 9. In fact, BTI points out that the rolling average type of productivity factor being considered by the Commission "would fully reflect in the LECs' rates the productivity gains achieved through the use of integrated networks."

[39]BTI at 9-10.

ratepayers will share in the benefits of economies of scope through price cap regulation's productivity factor methodology.[40]

Compared to the status quo of a stand-alone telephone network, telephone customers of a price cap LEC are better off if the LEC is allowed, without regulatory penalty, to build an integrated broadband network capable of furnishing advanced regulated services as well as video programming. Price cap regulation prevents any increases in telephone rates to fund video programming, but the telephone customers nonetheless receive the benefits of upgrades and improvements in regulated services made possible in part by the video programming use of the network. Consequently, it would be harmful to consumer welfare to penalize the LEC by reducing telephone prices each time the regulated network is used for another type of nonregulated service.[41]

In any event, such an application of price cap rules would be contrary to the fundamental objectives of price cap regulation of severing the relationship that existed under rate-of-return regulation between accounting costs and rates.[42]

V. CONCLUSION

Relying on the incentives created by competition and applying price cap regulation in a manner that emulates the operation of competitive forces, the Commission should reject requests

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[40] Bell Atlantic at 6; BellSouth at 14; BTI at 9; PacTel at 17-18; USTA at 13.

[41] Sidak Affidavit at 15; Bell Atlantic at 5.

[42] Pactel at 16-17; Taylor Affidavit at 5.

to resurrect regulation as intensive as the Title II regulation of video dialtone.[43] Instead of adopting mandatory uniform fixed factors or other arbitrary cost allocation methods which fail to consider the growing differences between network architectures, services, markets and LECs and which discourage LEC investment in broadband networks to provide advanced regulated and nonregulated services, the Commission should continue to rely, to the extent still necessary, on Part 64's cost-causative direct and indirect attribution methods. No one has proven that Part 64's attributable cost method is so incapable of accomplishing its intended purposes that it should be replaced by factors arbitrarily designed to over-allocate costs to new services. Imposition of inflexible cost allocation rules and punitive use of the exogenous cost rule not only would impede effective competitive entry into the concentrated video market[44] but also would discourage efficient deployment of advanced telecommunications infrastructure necessary to provide advanced services to hospitals, schools and libraries, as contemplated by the 96 Act.

The deregulatory intent of the 96 Act requires that the Commission consider the least burdensome alternative to accomplish its proper regulatory duties. With price cap regulation and competition as effective safeguards against cross-subsidy in its true economic sense, the Commission can safely streamline Part 64 for price cap LECs, without shirking any of its duties. To the extent Part 64 is retained for rate-of-return LECs, it should apply equally to the dominant players in the video marketplace as they enter the telecommunications business. However, in no

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[43] See 47 U.S.C. §651(a)(3) & (4) (describing the Title VI provisions that apply to LECs' cable and open video systems).

[44] If incumbent cable operators begin to offer free basic cable service, competitive entry by LECs may be effectively precluded by cost allocation rules that force excessive cost recovery on LECs' video programming. See In the Matter of US West Communications, Inc., 10 FCC Rcd 12184, 12187 n. 57 (1995) (discussing Cox's plans to provide 21 cable service channels free of charge).

event are the extreme measures suggested by cable commenters (e.g., fixed factors, "stand-alone" system cost ceilings) or the rigid methods proposed in the NPRM justified as the least burdensome means of accomplishing the Commission's regulatory objectives, consistent with the pro-competitive spirit of the 96 Act.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Kelly Brickey, hereby certify that the foregoing "Reply Comments of Southwestern Bell Telephone Company", have been served June 12, 1996 to the Parties of Record.

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